

# THE IMPACT OF FINANCIAL PERFORMANCE ON FIRM VALUE: THEORETICAL APPROACHES AND PRACTICAL IMPLICATIONS

Assoc. Prof. PhD Laura Vasilescu  
University of Craiova  
Faculty of Economics and Business Administration  
Craiova, Romania

## **Abstract:**

*This paper explores the relationship between financial performance and firm value, focusing on how financial indicators affect market valuation. The study integrates relevant contributions from corporate finance literature and highlights the central role of profitability, capital structure, and firm size in the value creation. The analysis is framed in the context of emerging markets, with references to the Romanian capital market. The study emphasizes the importance of sustainable financial performance and prudent risk management for enhancing firm value, providing practical insights for investors and managers.*

JEL classification: G30, G32, G12

**Key words: financial performance, firm value, profitability, capital structure, emerging markets**

## **1. INTRODUCTION**

Maximizing firm value represents the central objective of modern financial management, reflecting the firm's ability to generate sustainable future cash flows adjusted for the level of risk accepted by investors (Brealey et al., 2020). Financial performance plays a crucial role in this process, providing relevant information regarding the efficiency of resource utilization and the soundness of the firm's financial position.

Investors use financial performance as a primary criterion in the evaluation process and in investment decisions (Damodaran, 2012). Financial indicators derived from financial statements enable comparative analyses across firms and industries, thereby contributing to the formation of market value (Penman, 2013). However, the relationship between financial performance and firm value is complex and nonlinear, being influenced also by market expectations, capital structure, and the broader economic environment.

In emerging markets such as Romania, this relationship has specific characteristics generated by lower market liquidity, the structure of investors, and the sensitivity to risk (Davydov, 2016). Moreover, financial performance is not limited to the accounting profit. This also encompasses the firm's ability to generate stable and predictable cash flows and is influenced by institutional factors, corporate governance, and environmental and social practices (Bashir et al., 2023; Rodríguez Valencia, 2025).

The main objective of this paper is to examine, based on existing literature, how financial performance affects firm value and to highlight the practical implications for investors and managers, with a focus on the Romanian capital market context.

## **2. LITERATURE REVIEW**

### **2.1. Financial performance of the firm**

A firm's financial performance indicates how effectively it has utilized its resources in order to generate economic results during a specific time frame. According to Helfert (2001), financial performance should be analyzed from an integrated perspective that includes profitability, liquidity and risk.

In the literature, financial performance is often associated with value creation and it is considered a direct determinant of a firm's attractiveness to investors (Palepu et al., 2025). Thus, performance is not reduced to accounting profit alone but also includes the firm's ability to generate stable and predictable cash flows. Recent studies emphasize that investors increasingly value not only the level of financial performance but also its sustainability, assessed through earnings stability and the firm's ability to maintain long-term competitive advantages (Penman, 2013; Koller et al., 2025). In this context, financial performance is perceived as a signal of management quality and strategic decisions, directly influencing market perceptions of firm value.

To assess financial performance, researchers commonly rely on various metrics calculated from a company's financial reports. The most commonly used indicators include: profitability ratios (ROA, ROE), which measure the efficiency of asset and equity utilization; liquidity ratios, reflecting the firm's ability to meet short-term obligations; solvency ratios, highlighting capital structure and leverage; and efficiency ratios, which measure asset turnover and working capital management (Ross et al., 2024). These indicators are employed both in internal analysis and external firm evaluation, playing a significant role in estimating firm value.

### **2.2. Firm value**

Firm value represents the economic expression of future benefits anticipated by investors. According to Damodaran (2012), a firm's value is determined by the level of future cash flows, the timing of their realization and the associated risk.

Unlike book value, which reflects historical data, market value is future oriented and incorporates investors' expectations. This value is directly influenced by reported financial performance and the credibility of financial information (Penman, 2013).

The main valuation methods used in financial practice include discounted cash flow (DCF) analysis, market multiples, and adjusted book value methods. Among these, the DCF method is considered the most important theoretically, as it establishes a direct link between future financial performance and firm value (Brealey et al., 2020).

The literature highlights that financial markets react rapidly to information regarding financial performance, which is reflected in stock prices. Firms with superior financial performance tend to achieve higher market valuations, while poor performance is penalized through declines in market value (Koller et al., 2025). Moreover, empirical research demonstrates that strong ESG (Environmental, Social, and Governance) performance enhances firm valuation in emerging markets (Bashir et al., 2023; Li, 2024). This relationship is largely driven by improved transparency, stronger governance structures, and superior risk management, which reduce information asymmetry and increase investor confidence.

Consequently, analyzing the relationship between financial performance and firm value is an essential approach for understanding the mechanisms of value creation and for supporting investment and managerial decisions in a company.

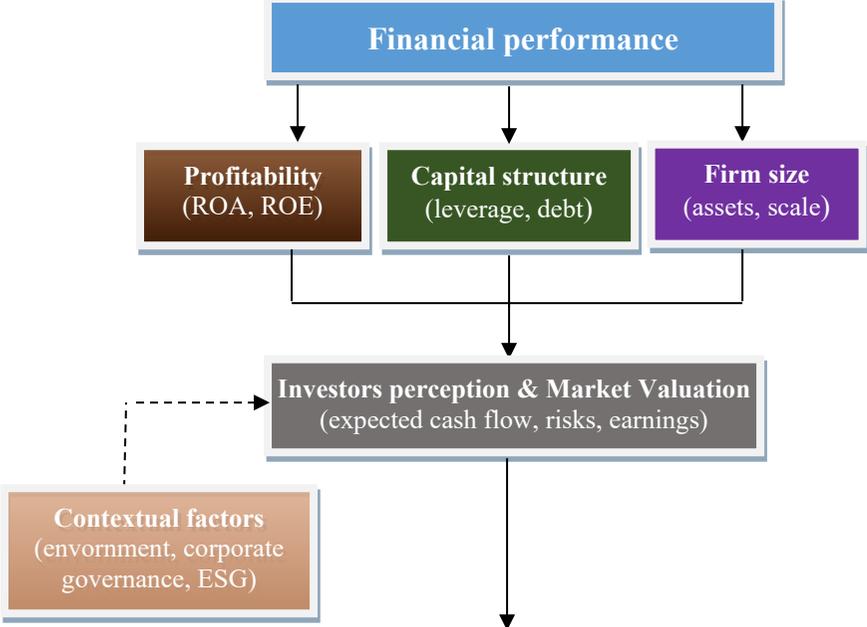
### 2.3. The relationship between financial performance and firm value

Classical finance models, notably Modigliani and Miller (1958), highlight cash flows and capital structure as key determinants of firm value, whereas more recent approaches additionally incorporate operational performance and managerial decision-making (Ross et al., 2024).

Empirical studies in developed markets generally indicate a positive relationship between profitability and market value, measured by indicators such as Tobin’s Q or the Market-to-Book ratio (Penman, 2013). Profitability is interpreted as a signal of competitive advantages and superior capacity to generate cash flow, contributing to higher market valuations. Financial performance influences firm value through increased cash flows and reduced risk perceived by investors (Gaio & Raposo, 2011; Vintilă, 2024). Also, recent studies indicate that firms with high returns on invested capital tend to achieve higher market values (Koller et al., 2025).

In emerging markets, the relationship between financial performance and firm value is more complex and heterogeneous compared to developed markets. Some studies emphasize the increased sensitivity of firm value to capital structure and financial risk (Davydov, 2016). Moreover, this relationship is influenced not only by traditional indicators such as profitability but also by institutional characteristics, corporate governance, environmental and social factors. The research highlights the crucial role of corporate governance and financial reporting quality in enhancing transparency and reducing perceived risk, thereby positively influencing firm value in emerging market environments (Braga-Alves & Morey, 2012; Ciurel & Dobrescu, 2026).

The conceptual framework showing how financial performance influences firm value through key financial indicators and investor perception is presented in figure 1.



## Firm value

### Figure 1. Relationship between financial performance and firm value

Source: author's own elaboration based on the conceptual framework

Therefore, the financial performance through profitability, capital structure, and firm size, shapes investor perception and market valuation, ultimately influencing firm value. However, other contextual factors such as institutional characteristics, corporate governance, and environmental and social aspects should also be considered.

Nevertheless, the literature also points to limitations of this relationship. Thus, short-term financial performance may be influenced by accounting policies or cyclical factors without reflecting the firm's real economic value. In such cases, investors place greater emphasis on earnings quality and growth prospects. These differences justify the need for empirical analyses focused on specific markets, such as Romania.

### 3. IMPACT OF FINANCIAL PERFORMANCE ON FIRM VALUE: IMPLICATIONS FOR INVESTORS AND MANAGERS

#### 3.1. Implications for Investors

Understanding the relationship between financial performance and firm value is crucial for investors aiming to make well-informed decisions. Theoretical evidence points to several key implications for investors:

- *Profitability as a signal of value.* Profitability ratios, such as Return on Assets (ROA) and Return on Equity (ROE), indicate the firm's ability to generate sustainable returns. Investors can use these indicators to identify firms with stable cash flows and long-term growth potential (Penman, 2013; Koller et al., 2025). Firms with higher profitability are more likely to deliver consistent dividends and capital gains, enhancing total investor returns.

- *Capital structure considerations.* Theoretical frameworks underline the importance of debt management on the investors decisions. Excessive leverage increases financial risk, especially in emerging markets, and can negatively affect firm valuation (Davydov, 2016; Le & Phan, 2017; Alanazi, 2019). Investors should assess the debt-to-equity ratio alongside profitability to gauge the firm's resilience under market fluctuations.

- *Firm size and market perception.* Larger firms tend to benefit from economies of scale, stronger governance practices, and higher visibility in financial markets. These characteristics often lead to lower perceived risk and enhanced investor confidence (Alabdulkarim et al., 2024; Vintilă, 2024).

- *Sustainability, quality of earnings and ESG factors.* Investors are increasingly attentive to the quality and predictability of earnings, rather than short-term profit levels alone (Gaio & Raposo, 2011). Moreover, companies that demonstrate consistent, transparent financial performance alongside strong ESG commitments signal effective management, long-term sustainability, and lower investment risk.

Overall, by integrating assessments of profitability, capital structure, firm size, and earnings quality, investors can make more informed decisions and better identify firms capable of delivering sustainable long-term value.

### 3.2. Implications for Managers

Managers play a critical role in translating financial performance into firm value. Theoretical insights highlight practical actions that can enhance investor confidence and market valuation:

- *Prioritize sustainable profitability.* Management should focus on strategies that not only increase short-term profits but also maintain consistent long-term earnings. This includes optimizing operational efficiency, controlling costs, and investing in projects with reliable cash flow generation (Brealey et al., 2020; Koller et al., 2025).

- *Maintain prudent capital structure.* Managers should carefully balance debt and equity financing. Excessive leverage can reduce investor confidence, particularly in volatile emerging markets (Davydov, 2016; Alanazi, 2019).

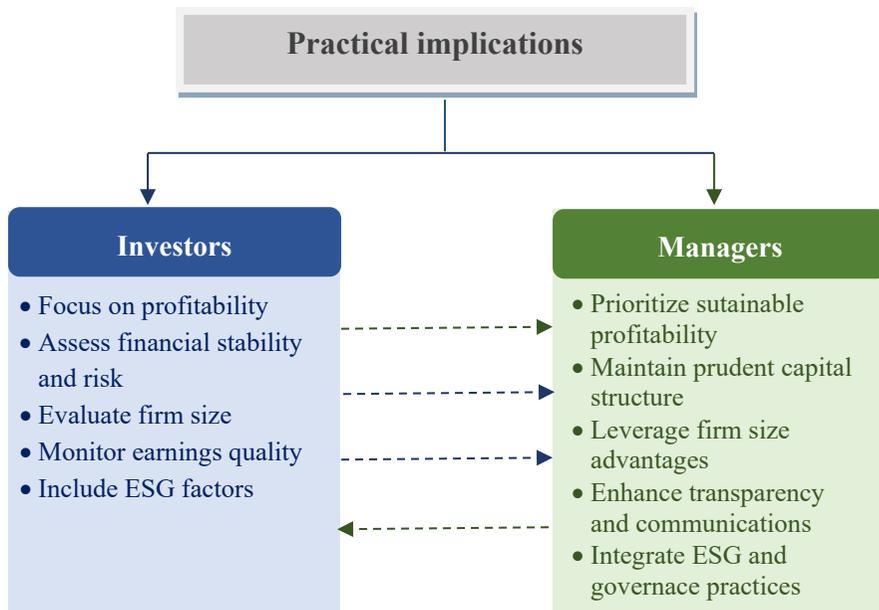
- *Leverage firm size advantages.* Larger firms can strengthen market perception through operational stability, brand recognition, and better access to financing (Alabdulkarim et al., 2024; Vintilă, 2024).

- *Enhance transparency and communication.* Clear and consistent communication of financial performance, strategic goals, and risk management could increase investor perceptions (Penman, 2013; Ciurel & Dobrescu, 2026).

- *Integrate ESG and governance practices.* Strong corporate governance and ESG initiatives positively affect perceived firm value, particularly in emerging markets where transparency is critical (Li, 2024; Rodríguez Valencia, 2025).

By implementing these practices, managers can not only enhance investor confidence but also foster sustainable long-term firm value, aligning operational decisions with market expectations and governance standards.

Figure 2 illustrates the practical implications of financial performance for both investors and managers, highlighting the key areas where each group should focus to enhance firm value and market perception and the necessary connections.



**Figure 2. Financial performance and firm value: practical implications**

## **for investors and managers**

*Source: author's own elaboration based on the conceptual framework*

The figure illustrates how key aspects of financial performance influence firm value through both investor perception and managerial actions. Profitability signals a firm's ability to generate sustainable earnings and long-term growth, while capital structure affects perceived financial risk, with prudent debt management enhancing investor confidence.

The firm size contributes to market perception by conveying operational stability, visibility, and economies of scale. Transparency and ESG initiatives further strengthen investor trust by ensuring clear communication of performance and responsible governance. Ultimately, managerial decisions - that integrate these factors - drive the creation and enhancement of firm value. Therefore, the practical actions taken by managers and the evaluation criteria used by investors are interconnected, shaping market perception and ultimately influencing firm value.

### **3.3. Strategic Takeaways**

Based on these insights, the investors should combine traditional financial indicators with qualitative assessments of management quality and sustainability in order to evaluate firm value accurately. Managers, in turn, should focus on long-term value creation, not merely short-term profitability, ensuring that operational decisions, capital structure, and reporting practices reinforce investor confidence.

In emerging markets such as Romania, the relationship between financial performance and firm value has unique characteristics due to market-specific factors, including liquidity constraints and risk sensitivity. Liquidity constraints reflect the limited number of active market participants, which can make it harder to buy or sell shares without affecting prices, while risk sensitivity indicates that firm value reacts more sharply to economic or financial shocks than in more developed markets.

Strategic takeaways emphasize that maximizing firm value is not limited to improving short-term performance but requires a holistic approach integrating financial, operational, and governance factors. Firms that combine sustainable profitability with prudent financial management, operational efficiency, and transparent reporting are more likely to achieve favorable market valuations.

## **4. CONCLUSIONS**

The theoretical analysis highlights that financial performance is a critical determinant of firm value. Profitability, capital structure, and firm size play central roles in value creation, influencing investor perception and market valuation.

In emerging markets such as Romania, the relationship between financial performance and firm value is shaped by market-specific factors, including perceived risk and capital market development. The study's findings offer valuable insights for investors and managers, emphasizing the need for sustainable performance and financial transparency. Key theoretical insights of the study include:

- profitability serves as a strong signal of a firm's ability to generate sustainable cash flows, directly contributing to higher market valuations;
- capital structure affects perceived financial risk - excessive leverage can reduce investor confidence and negatively influence firm value;

- firm size enhances operational stability, economies of scale, and market visibility, all of which positively influence market perception.

Practical implications for market participants are closely aligned with these theoretical insights:

- for *investors*, profitability, financial stability, and transparent governance practices should guide firm selection. Evaluating firms solely on short-term growth or accounting profits may overlook value drivers in the long-term. Sustainability, earnings quality, and ESG practices are increasingly relevant criteria in emerging markets;

- for *managers*, strategic decisions must balance profitability, prudent debt management, and operational scale. Clear communication of financial performance, risk management policies, and long-term growth strategies strengthens investor confidence and enhances firm value. Adopting robust governance and sustainable practices further supports valuation, particularly in markets where transparency is critical.

This study has several limitations. First, it is primarily theoretical and does not use financial data from listed firms, limiting the ability to test statistical relationships. Second, it focuses on profitability, leverage, and firm size, while other factors such as sector dynamics, innovation, or ownership structure are not considered. Third, the findings are context-specific and may not fully generalize to other markets. Therefore, the future research could extend these insights through empirical analysis of Romanian listed firms or comparative studies across other emerging markets, incorporating additional variables such as innovation, sectoral strategies, sustainability practices, and ESG factors.

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